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In the Supreme Court of the United States

OCTOBER TERM, 1988

UNITED STATES OF AMERICA, PETITIONER

v.

THE GOODYEAR TIRE AND RUBBER COMPANY AND AFFILIATES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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This case concerns the construction of a provision of the Internal Revenue Code applicable to the determination of the United States income tax of United States corporations. The question presented concerns the determination under Section 902 of the Code of the "deemed paid" foreign tax credit, which is available to a domestic corporation that receives dividends from a foreign subsidiary that has paid foreign income tax. Specifically, the issue in this case is the meaning of the term "accumulated profits" in Section 902. Departing from the settled rule, the court of appeals held that this term in the Internal Revenue Code refers to profits as computed under foreign law principles; we maintain that it refers to profits as computed under principles of United States law.

We argued in our petition that the court of appeals' interpretation is clearly at odds with congressional intent for

a multitude of reasons. Respondent does not dispute several of the points made in the petition: (1) that the proration of the credit should reflect the ratio that dividends actually paid bears to potential dividends, and therefore that it is inconsistent to compute the "dividends" included in United States income according to United States law (as is undisputed) while computing the "accumulated profits," out of which the dividends are paid, under foreign law (Pet. 13-16); (2) that the court of appeals' interpretation seriously disrupts the proper functioning of the credit and leads to irrational results (Pet. 16); (3) that the decision below undermines the statutory goal of avoiding discrimination between companies that operate through a foreign branch and those that operate through a foreign subsidiary (Pet. 19-22); and (4) that the court of appeals' "plain meaning" approach is faulty because the statute itself states that dividends are paid out of "accumulated profits" (Pet. 13-14). Moreover, respondents' objections to the other points made in our petition are without merit.

1. We noted in our petition (at 5 n.4) that the court of appeals' decision leads to favorable tax consequences for respondent in two different respects: the Section 902 formula allows it a credit for a greater percentage of the foreign taxes paid in 1970; and, under the annualization approach of Section 902 (see Pet. 4 n.3), the reduction in 1971 "accumulated profits" allows respondent to treat the 1971 dividend as having been paid in part out of profits earned in earlier years, thus allowing it to take a Section 902 credit on its 1971 federal income tax return for foreign taxes paid in the years 1968 and 1969 as well. Respondent asserts that this latter feature of the case, which it terms "sourcing" the dividend, is critical to its resolution. See Br. in Opp. 3-7. In fact, the concept of "sourcing" is quite collateral to the threshold question presented here—whether

the profits to which the dividends are sourced are computed under foreign law or under the law of the United States. Only after that question is answered can the sourcing calculation be made.

Respondent argues (Br. in Opp. 5-7) that domestic concepts of taxable income and of earnings and profits cannot be relevant to the process of "sourcing," and therefore cannot be used to detemine "accumulated profits," because the profits in question are those of a foreign corporation that is not directly subject to United States taxation. Respondent's argument appears to rest on the idea that, because its subsidiary is subject to foreign tax, the dividends it received from the subsidiary should be deemed to have been paid out of the latter's profits as computed by British law. This analysis is fundamentally misconceived. This case involves the federal income taxation of United States corporations. The Section 902 credit grants relief from federal taxation with respect to the dividends that a domestic company receives from a foreign subsidiary and reports as income on its United States return. Just as United States law determines how much of the distribution constitutes a "dividend"—by looking to whether the money was paid out of "earnings and profits"—so it must also determine the "accumulated profits" out of which the dividend is paid.[1]

Respondents' objection to the government's interpretation on the ground that it permits dividends to be at-

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[1] Indeed, respondent recognizes that "accumulated profits" must be correlated with the source of the dividends. Respondent notes that "[t]he determination of [dividends] for each year depends on the 'accumulated profits' for the year, since the dividend is allocated according to the profits available for paying it" (Br. in Opp. 5). The "profits available for paying" a dividend received by a United States taxpayer are defined by Section 316 of the Code as "earnings and profits," which are computed under United States law. See I.R.C. § 312.

tributed to the accumulated profits of a year in which "there appears to be profit but no foreign tax" (Br. in Opp. 5) is unfounded. This result is no "distortion of the credit" (*id.* at 7); rather, it is the necessary and appropriate consequence of the favorable tax treatment allowed to respondent's subsidiary by British law. As we explained in the petition (at 19), because British law permitted a loss and carryback to 1970 and 1971 not available under United States law, the subsidiary's profits for those years when computed under United States law were much higher than under British law, *and the subsidiary paid no tax to Britain on those additional United States profits.* Those profits computed under United States law were sufficient to cover the dividends that the subsidiary distributed in 1970 and 1971, and the Commissioner accordingly "sourced" those dividends to those profits for purposes of computing the Section 902 credit. See Pet. App. 23a-24a. Since the subsidiary paid no foreign tax on the additional "United States profits," there was no danger that those profits would be subjected to double taxation when distributed as dividends includable in respondent's United States income. Under the statutory scheme, respondent simply is not entitled to any foreign tax credit with respect to those profits—a manifestly reasonable result since it paid no foreign tax on them. By contrast, respondent's position distorts the credit and seeks a substantial windfall by treating the dividends in question as a distribution of profits earned in prior years when the subsidiary paid higher taxes to Britain—profits that have not yet been distributed to respondent under the governing rules of Sections 312 and 316 of the Code.

2. a. Respondent disputes (Br. in Opp. 11-13) our contention (see Pet. 9-12) that the decision below overturns a rule that was recognized by the Tax Court and well

settled by more than 50 years of uniform administrative practice and a Treasury Regulation directly in point. Instead, respondent suggests that the Commissioner did not definitively declare that United States principles govern the determination of "accumulated profits" until prompted to do so by this litigation, arguing that previous rulings and regulations addressed to the subject were ambiguous at best. Respondent's contentions are without merit.

As stated in the petition (at 9-10), the Commissioner issued a ruling in 1933 to the effect that special deductions and similar items allowed by a foreign country as offsets to taxable income, but not allowed as deductions under United States tax laws, do not reduce accumulated profits for purposes of the Section 902 credit. The ruling explained that accumulated profits include "all income of the foreign corporation available for distribution to its shareholders, whether such profits be taxable by the foreign country or not." I.T. 2676, XII-1 C.B. 48, 50 (1933). The inventory adjustments and accelerated depreciation that respondent's subsidiary claimed under British law are examples of "special deductions," which the ruling specifies do not serve to decrease accumulated profits. The position taken by the Treasury in this case is therefore no different from the one it announced in 1933.

Since the publication of the 1933 ruling, the Treasury has consistently followed the principle that "accumulated profits" are determined by United States law. In 1963, it promulgated a Revenue Ruling that quoted the 1933 ruling with approval and concluded that the calculation of accumulated profits is based on the concept of earnings and profits in Section 316 of the Code. Rev. Rul. 63-6, 1963-1 C.B. 126. Even respondent recognizes that this Revenue Ruling squarely holds that "U.S. rules should govern the determination of 'accumulated profits' " (Br. in Opp. 11),

and the Commissioner has never departed from this ruling.[2]

Respondent's assertion (Br. in Opp. 12) that the applicable Treasury regulation, Treas. Reg. § 1.902-3(c)(1) (1965), departs from Rev. Rul. 63-6 and "essentially support[s]" respondent's position is misconceived. As we stated in the petition (at 10), the definition of "accumulated profits" of a foreign subsidiary in this long-standing regulation unequivocally correlates them with its "earnings and profits." Respondent adverts to a different paragraph of the regulation, Treas. Reg. § 1.902-3(c)(4) (1965), that does not define the term "accumulated profits," but rather construes the statutory phrase "taxes paid * * * on or with respect to such accumulated profits." As explained in the petition (at 16-18 & n.7), this is the

[2] Respondent's assertion (Br. in Opp. 11) that the Treasury reversed itself by later declaring this ruling "obsolete" (see Rev. Rul. 72-261, 1972-2 C.B. 651) is plainly unfounded. The ruling was never revoked; it is common for a ruling to be classified as "obsolete" (*i.e.*, not controlling for future transactions) when the ruling has become "unnecessary because the issue has been covered by regulations" (Rev. Proc. 67-6, 1967-1 C.B. 576, 577). That is precisely what occurred here. The ruling construed Section 902 as it read before amendment by the Revenue Act of 1962. Subsequent to that statutory change, the Treasury promulgated a formal regulation, Treas. Reg. § 1.902-3(c)(1) (1965), interpreting the amended statute. Because that regulation embodied the substance of Rev. Rul. 63-6 and construed the new version of the statute, the ruling was properly declared "obsolete" under the criteria developed by the Treasury for reducing the number of outstanding rulings. Rev. Rul. 63-6 and the regulation, now codified in its present form as Treas. Reg. § 1.902-1(e), continue to be recognized as embodying Treasury's position that "accumulated profits" are computed in accordance with the principles governing the calculation of earnings and profits under United States law. See S. Rep. No. 313, 99th Cong., 2d Sess. 299 n.6 (1986); *Champion International Corp.* v. *Commissioner*, 81 T.C. 424, 433 (1983).

statutory phrase that gave rise to the so-called *American Chicle* limitation. The purpose of this paragraph of the regulation is to reflect the change made by the Revenue Act of 1962 and make clear that the foreign tax "paid * * * with respect to such accumulated profits" equals the entire foreign tax without reduction on account of the *American Chicle* limitation. See Pet. 17 n.7. Nothing in this paragraph undermines the explicit definition in subparagraph (1) of "accumulated profits" in terms of "earnings and profits" computed under United States law; indeed, the paragraph quoted by respondent specifically incorporates that definition.[3]

b. Respondent's assertion (Br. in Opp. 8, 11-12) that *Champion International Corp.* v. *Commissioner*, 81 T.C. 424 (1983), in which the Commissioner acquiesced, decided the issue presented in this case in respondent's favor is without foundation. *Champion* involved a different issue. The foreign subsidiary in that case, unlike respondent's subsidiary, sustained a loss that could be carried back under both United States tax law and the tax law of Canada. The question in the case was the year in which the loss should be recognized for purposes of computing "accumulated profits." The Tax Court's holding permitting the carryback sought by the taxpayer thus was fully con-

[3] Seizing on a misstatement by the Claims Court (Pet. App. 26a), respondent asserts (Br. in Opp. 7, 12, 15) that the term "gains, profits, and income" necessarily refers to profits computed under foreign tax principles and therefore contends that subparagraph (4) of the regulation directly supports its position. This contention is clearly mistaken. The phrase relied upon by respondent is taken directly from the statutory definition of "accumulated profits" (I.R.C. § 902(c)(1)). If that phrase had a recognized meaning as income determined under foreign law principles, it would be unnecessary to look beyond Section 902(c)(1) to resolve this case. In fact, the meaning of that phrase is the question presented here, not the answer.

sistent with the government's position here. Indeed, the court so stated, noting that "[t]he accumulated profits in the denominator [of the Section 902 fraction] represent the fund from which the dividends were paid and must be determined in accordance with U.S. law" (81 T.C. at 433; see also *id.* at 431).[4] As noted in our petition (at 11), the court went on to distinguish and reaffirm its earlier decision in *Steel Improvement & Forge Co.* v. *Commissioner,* 36 T.C. 265, 276-282 (1961), rev'd on other grounds, 314 F.2d 96 (6th Cir. 1963), which held that "accumulated profits" must be determined under United States law (see 81 T.C. at 446-447). In *Steel Improvement,* as here, the loss claimed by the foreign subsidiary was allowed only by foreign law, and the Tax Court accordingly held that it could not be used to offset the subsidiary's accumulated profits. Respondent does not dispute our characterization of *Steel Improvement* as directly in point.

Thus, in the words of a commentator on the decision below, the Federal Circuit has "adopted an approach to the § 902 deemed paid credit fraction which is different from the generally accepted view that (E & P) and accumulated profits are computed in accordance with U.S. concepts * * *." Fuller, *Section 902 Accumulated Profits: The Federal Circuit Takes a Different View in* Goodyear, 17 Tax Mgmt. Int'l J. (BNA) 502, 503 (1988). That generally accepted view is reflected in the Tax Court's deci-

[4] Similarly, respondent errs in suggesting (Br. in Opp. 13) that the Commissioner acted inconsistently in allowing respondent to consider a loss sustained by its British subsidiary in 1972 in computing its foreign tax credit. The loss incurred in 1972 was not "similar" to the one involved here; it was a loss recognized under both United States and British tax law (see Pet. App. 10a). Thus, the 1972 loss was akin to the loss in *Champion* and dissimilar in a critical respect from the 1973 loss involved here.

sions, the published position of the Treasury, and numerous commentators on the foreign tax credit.[5] The decision below departing from that view is unfounded and threatens serious disruption of the fair administration of the foreign tax credit provisions.

3. Respondent asserts that the issue in this case is not sufficiently important to merit review by this Court (Br. in Opp. 8-9), but it does not refute our submission (Pet. 22-26) that the decision below is of enormous importance to the public fisc and places the IRS in a whipsaw posture with respect to the Section 902 credit claims of multinational corporations. Moreover, as we explained in our petition (at 24-26), the issue in this case retains continuing significance even after the enactment of the 1986 Tax Reform Act because the pre-1986 method for computing the foreign tax credit has been retained indefinitely for dividends paid from pre-1987 profits—a fact that has been duly noted by tax practitioners. See Fuller, *supra*, 17 Tax Mgmt. Int'l J. (BNA) at 503 (decision below "could have a major impact on foreign tax credit planning"); Burda, *The Foreign Loss Carryback Dilemma: Gone But Not Forgotten*, 13 Int'l Tax J. 199, 224 (1987) (treatment of foreign losses "is still a problem" after 1986 Act and "will not be eliminated until all pre-1987 accumulated profits are finally repatriated as dividends to the U.S. shareholders"). In short, the decision below raises a substantial and continuing impediment to the proper administration of the foreign tax credit.

[5] See, e.g., Pet. 11 n.5; *Federal Income Tax Project: International Aspects of United States Income Taxation* 398 (A.L.I. 1987); Mentz, *The Effect of Net Operating Losses on the Foreign Tax Credit,* 30 Tax Law. 309, 324 n.36, 333 (1977); Burda, *The Foreign Loss Carryback Dilemma: Gone But Not Forgotten*, 13 Int'l Tax J. 199, 206 (1987).

For the foregoing reasons, and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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Acting Solicitor General

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